the interLATA market, all of which would have been available for the BOCs to use even more forcefully in the intraLATA market, it is a wonder that they entered intraLATA markets of their own accord. If IXCs really believed that BOCs are effective at discriminating, surely they would have avoided the intraLATA market.

40. It is often opined by those opposed to BOC interLATA entry that no regulatory safeguards are sufficient to prevent discrimination because the BOCs will be able to subtly cloak discriminatory conduct as legitimate business practices. These opinions assume a considerable degree of gullibility and naiveté on the part of regulators. In my experience, and as one who has advocated an even greater degree of deregulation than has occurred, I believe that regulators generally have a realistic, if not exaggerated, understanding of an integrated firm's incentives, and are obdurately suspicious about the actions of regulated companies in this regard.

C. Examples of Competition with BOCs Before the Act

41. The actions of IXCs and others in voluntarily competing in the intraLATA and local exchange markets provided hard evidence to convince Congress that it was no longer necessary to maintain an entry barrier keeping BOCs out of the interLATA market during the transition to competition in the local exchange in order to protect competition in the interLATA market. Although local exchange competition is clearly desirable for the beneficial impacts of competition in the local exchange market itself, it also will reduce and then obviate the need to rely on regulation to oversee competition. The advent of local exchange competition will make it even more likely that there will be fair competition in the interLATA market.

42. The Act only requires the opening of competition in the local exchange as a prerequisite to BOC interLATA entry; however, the Commission should take note of the development of actual local exchange competition in Oklahoma and throughout the rest of the country as further evidence of the BOCs' inability to engage in discriminatory practices, and thus in support of BOC entry into all telecommunications markets. In Oklahoma, as of February 14, 1997, SWBT has negotiated fifteen interconnection agreements, five of which

have been approved by the Oklahoma Commission.[25] Six of the fifteen negotiated agreements are with facilities-based carriers, and three of the approved agreements are with facilities-based carriers.[26] Indeed, SWBT in its region has been in the vanguard of BOCs in reaching interconnection agreements with potential competitors.

43. The development of actual, facilities-based competition in the local exchange in Oklahoma, in addition to opening the local exchange to competition as required in the Act and as demonstrated by compliance with the checklist, is further evidence that Southwestern Bell will not be able to use its position as a local exchange carrier as an anticompetitive advantage in the interLATA market.[27] In order for a vertically-integrated company to discriminate in the downstream competitive market, other downstream competitors must be unable to avail themselves of alternative suppliers of essential inputs. The fact that there are competitors in the local exchange market in Oklahoma, coupled with the ability of IXCs to use unbundled network elements as an alternative to SWBT's access, indicates that downstream competitors can avail themselves of alternative suppliers. This fact undermines SWBT's ability to discriminate. I call what Congress has developed for BOC interLATA entry a "belt and suspenders" approach. The Act's regulatory safeguards are the "belt" to hold up fair competition in the interLATA market during the transition to a fully competitive local exchange market, and the actual development of competition is the "suspenders."

VII. CONCLUSION AND SUMMARY

44. At the time of divestiture, it was generally assumed that the local exchange was a natural monopoly, and that only long distance service and CPE could be provided competitively. In order to promote competition in long distance, however, the Justice Department believed that it was necessary to fully separate the local exchange business from

[25] Affidavit of Robert E. Stafford, page 7.

[26] Id., page 8.

[27] A similar conclusion holds for intraLATA toll competition.

the long distance business via a corporate divestiture of AT&T. In addition, it was decided at that time that the Bell Operating Companies, which would maintain the "natural" monopoly in the local exchange, should not be allowed to reintegrate into the long distance market. Almost from the start, the BOCs have argued on efficiency and general competitive grounds for removal of the MFJ's line-of-business restrictions, particularly that which kept them out of the long-distance market. However, it is the opening of the local exchange market to competition along with the almost immediate backwards reintegration of the interexchange carriers and others into the intraLATA toll and local exchange market that provides the most compelling argument for allowing the BOCs, including Southwestern Bell, to enter all communications markets, including the interLATA market.

45. The incumbent interexchange carriers, who argue strenuously that the BOCs should not be allowed to compete against them in their "home" interLATA market, began competing against the BOCs soon after divestiture in the intraLATA toll market and are now actively competing even in the local exchange. They clearly believe vertical integration is an important competitive strategy. If, as the now discarded MFJ theory says, the BOCs should not be allowed to compete in the interLATA market because their market power in the local exchange will give them unfair competitive advantages in the downstream market, why would interexchange carriers have left their protected interLATA market to compete against the BOCs in the BOCs' "home" markets? This point is crucial to an understanding of the economic reasoning underlying why Congress refused to mandate that there be a fully competitive market in the local exchange, as measured by traditional antitrust standards, prior to BOCs being allowed into the interLATA market.

46. Congress has explicitly required only that the feasibility of a competitive local exchange market for both residential and business customers be demonstrated prior to allowing BOCs into the interLATA market (through actual interconnection agreements or a state-approved statement of generally available terms and conditions). Congress has allowed the BOCs to participate in the interLATA market during the transition to a fully competitive local exchange market because Congress believes that regulators -- state and federal alike -- can effectively use their existing tools, coupled with those in the Act, to protect competition in the

interLATA market, even when the BOCs may still retain some level of market power in the local exchange. And the evidence for the effectiveness of regulatory tools in this respect is the voluntary participation of interexchange carriers and competitive local exchange carriers in the intraLATA toll and local exchange markets, which were opened to competition and protected by state regulators (with fewer safeguards than will exist in the interLATA market under the Act), in some cases right after divestiture. In summary, it makes little sense for the Commission to carefully establish a set of regulatory safeguards against anticompetitive practices, pronounce them sufficient, and not allow the market entry they were designed to allow to occur. The Commission therefore should immediately authorize SBLD to originate interLATA service in Oklahoma, in order to allow open competitive markets to achieve the purposes and goals of the Act for Oklahoma consumers.

47. Southwestern Bell has provided evidence of its compliance with all of the Act's requirements in Oklahoma, making it eligible to originate interLATA traffic in that state. Clearly such entry is in the public interest because the benefits of giving Oklahoma consumers the ability to choose SBLD for their interLATA service far outweigh the risk that Southwestern Bell will either subsidize its interLATA service or discriminate in favor of it.

KENNETH GORDON

Subscribed and sworn before me this 7th day of April 1997.

Notary Public

My commission expires: September 18, 2001

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Dr. Kenneth Gordon is a Senior Vice President with National Economic Research Associates, specializing in utility regulation and related issues. He was Chairman of the Massachusetts Department of Public Utilities from January 1993 to October of 1995. He came to the Massachusetts Commission from the Maine Public Utilities Commission, where he also held the office of Chairman from 1988 through the end of 1992. Prior to that, he was an Industry Economist at the Federal Communications Commission's Office of Plans and Policies. Prior to that, he taught at several colleges since 1965, the most recent position having been at Smith College.

Dr. Gordon was an active member of the National Association of Regulatory Utility Commissioners (NARUC) and served as president of that organization in 1992. He was also a member of the Executive Committee, and the Committee on Communications of NARUC. He has served as Chairman of the New England Conference of Public Utilities Commissioners Telecommunications Committee, and is a former Chairman of the Power Planning Committee of the New England Governors' Conference. He currently also serves as Chairman of the Bellcore Advisory Committee and is on several other boards and committees. Dr. Gordon has authored a number of publications and lectures widely on topics related to utility regulation.

Dr. Gordon is a graduate of Dartmouth College and holds a doctorate in economics from the University of Chicago.

EDUCATION

University of Chicago	Ph.D	1973
University of Chicago	M.A.	1963
Dartmouth College	A.B.	1960

EMPLOYMENT

November 1995 - **National Economic Research Associates, Inc.**, Washington, D.C.
Senior Vice President

October 1995 **Consulting Economist**

January 1993 - October 1995 **Massachusetts Department of Public Utilities**
Chairman

October 1988- December 1992 **Maine Public Utilities Commission**
Chairman

1980 - 1988 **Federal Communications Commission, Office of Plans and Policy**
Industry Economist

1965 - 1980 **University and College Teaching** (most recently at Smith College)

1963 - 1964 **University of Chicago**
Research Associate

CURRENT APPOINTMENTS AND MEMBERSHIPS

Bellcore Advisory Committee,
Member and Chairman, 1993 to present.

Telecommunications Policy Research Conference
Chair, 1995-1996
Board Member, 1994

Energy Modeling Forum (EMF 15, A Competitive Electricity Industry),
Stanford University
Member

American Economic Association

Transportation and Public Utilities Group, AEA

PAST APPOINTMENTS AND MEMBERSHIPS

National Association of Regulatory Utility Commissioners
Communications Committee, 1990 - 1995
Executive Committee, 1991-1995
President, 1992

New England Conference of Public Utility Commissioners
Power Planning Committee
Chairman

Governor's Electric Utility Market Reform Task Force
Co-Chairman

Boston University Telecommunications Forum
Advisor

Center for Public Resources, Legal Program to Develop Alternatives to Litigation
Chairman, Utilities Committee

Office of Technology Assessment, Advisory Panel on International Telecommunications Networks

ACTIVITIES

Participant in numerous regional and state committees, organizations, and task forces.

Participant in various NARUC/DOE conferences on gas and electricity issues.

Frequent speaker on electric, telephone and environmental issues nationally.

TESTIMONIES

Affidavit: in support of SBC Communications Inc.'s application to offer interLATA service in Oklahoma. Before the Oklahoma Corporation Commission and the Federal Communications Commission, filed February 20, 1997.

Before the Federal Communications Commission, on behalf of Ameritech: reply comments on access reform, filed February 14, 1997.

Before the Federal Communications Commission, on behalf of Ameritech: paper on access reform, "Access, Regulatory Policy, and Competition", filed January 29, 1997.

Before the Wisconsin Public Service Commission, on behalf of Ameritech - Wisconsin: testimony regarding interconnection arbitrations, filed December 5, 1996.

Before the Public Utility Commission of Texas, on behalf of Entergy-Gulf States Utilities: testimony regarding Entergy's "Transition to Competition" proposal, filed November 27, 1996.

Before the California Public Utilities Commission, testimony in support of the joint application of Pacific Telesis Group and SBC Communications Inc. for approval of their merger, Application No. 96-04-038, November 8-9, 1996.

Affidavit: in support of Florida Public Service Commission's appeal of Federal Communications Commission's interconnection order (CC Docket No. 96-98), September 12, 1996.

Before the New Jersey Board of Public Utilities on behalf of Bell Atlantic - New Jersey: "Economic Competition in Local Exchange Markets," position paper on the economics of local exchange competition filed in connection with arbitration proceedings, August 9, 1996 (with William E. Taylor and Alfred E. Kahn).

Before the Senate Committee on Commerce, Science and Transportation on FCC Structure and Function: Suggested Revisions, March 19, 1996.

Before the Federal Communications Commission in the Matter of Pricing for CMRS Interconnection on behalf of Ameritech, March 4, 1996.

Before the Senate Committee on Commerce, Science and Transportation on Telecommunications Reform on behalf of NARUC, March 2, 1995.

Before the House Committee on Energy and Commerce Committee, Subcommittee on Telecommunications and Finance on H.R. 4789, the Telephone Network Reliability Improvement Act of 1992, on behalf of NARUC, May 13, 1992.

Before the Senate Committee on Commerce, Science and Transportation on H.R. 2546, a bill proposing the Infrastructure Modernization Act of 1991, on behalf of NARUC., June 26, 1991.

SPEECHES (partial list)

Remarks before the 1996 Telecommunications Policy Research Conference, "Interconnection Principles and Efficient Competition", Solomon's Island, MD, October 7, 1996.

Remarks before the American Bar Association Section of Antitrust Law, "Charging Competitors and Customers for Stranded Costs: Competition Compatible?", Four Seasons Hotel, Chicago, IL, September 19, 1996.

Remarks before the 1996 EPRI Conference on Innovative Approaches to Electricity Pricing, "Prices and Profits: Perceptions of a Former Regulator," La Jolla, California, March 28, 1996.

Remarks before the Innovative Fuel Management Strategies for Electric Companies Conference sponsored by The Center for Business Intelligence, "Anticipating the Impact of Fuel Clause Reversal on Fuel Management," Vista Hotel, Washington, D.C., March 15, 1996.

Remarks before Electricity Futures Trading Conference, "Electricity Futures Trading: What the States Are Doing," Houston, Texas, March 14, 1996.

Panelist, "Regulatory Panel: Who Has Jurisdiction?" Public Power in a Restructured Industry, Washington, D.C., December 8, 1995.

Participant, "Public Policy for Mergers in a Time of Restructuring," Harvard Electric Policy Group, Crystal City, Virginia, December 7, 1995

Panelist, Roundtable on "Competitive Markets in Electricity and the Problem of Stranded Assets," Progress and Freedom Foundation, Washington, D.C., December 1, 1995.

Panelist on "The Range of Uncertainty" at the Illinois Electricity Summit, Northwestern University, Evanston, IL., November 28, 1995.

PUBLICATIONS

"The Regulators' and Consumer Advocate's Dilemma", *Purchased Power Conference*, Exnet, 1993.

"Public Utility Regulation: Reflections of a Sometime Deregulator", *Public Utilities Fortnightly*, Nov. 1, 1992.

"Utilities as Conservationists: One Regulator's Viewpoint', in *The Economics of Energy Conservation*, proceedings of a POWER Conference, Berkeley, CA, 1992.

"Incentive Regulation in Telecommunications: Lessons for Electric and Gas", in *Incentive Regulation*, Proceedings and Papers, 1992 (Exnet).

"Regulation: Obstructer or Enabler?", in *Proceedings; Cooperation and Competition in Telecommunications*, Conference sponsored by the Commission of the European Directorate General XIII, Rome, 1993.

"A Basis for Allocating Regulatory Responsibilities", in Clinton J. Andrews, (ed.), *Regulating Regional Power Systems*, Quorum Books, Westport, CT, 1995 (with Christopher Mackie-Lewis).

Book review: Stephen Breyer, *Breaking the Vicious Circle: Toward Effective Risk Reduction*, Harvard University, Press, 1992, in Federal Reserve Bank of Boston, Regional Review, 1994.

"Weighing Environmental Coasts in Utility Regulation: The Task Ahead", *The Electricity Journal*, October, 1990.

"The Effects of Higher Telephone Prices on Universal Service" Federal Communications Commission, Office of Plans and policy, Working Paper No. 10, March, 1984 (with John Haring).

"Are Recent FCC Telephone Rate Reforms a Threat to Universal Service" in Harry S. Trebing (ed.), *Changing Patterns in Regulation, Markets and Technology: The Effect on Public Utility Pricing*, University of Michigan Press, 1984 (with John Haring).

"A Framework for a Decentralized Radio Service, "a staff report of the Office of Plans and Policy, Federal Communications Commission, September, 1983 (with Alex Felker).

"L'impact de la television par cable sur les autres medias" (The Impact of Cable Television on other media in the United State"), *Trimedia*, numero 18019, printemps, 1983 (in French, also reprinted in Spanish).

"FCC Policy on Cable Ownership" in Gandy, Espinosa & Ordover, (eds.) *Proceedings from the Tenth Annual Telecommunications Policy Research Conferences*, ABLEX, Norward, N.Y., 1983.

"FCC Policy on Cable Crossownership", a staff report of the Office of Plans and Policy, Federal Communications Commission, November, 1981. (With Jonathan levy and Robert S. Preece; I was director of the study.)

"Economics and Telecommunications Privacy: A Framework for Analysis," Federal Communications Commission, Office of Plans and Policy, Working Paper No. 5, December, 1980. (With James A. Brown).

"The Effects of Minimum Wage on Private Household Workers" in Simon Rottenberg, (ed.), *The Economies of Legal Minimum Wages*, American Enterprise Institute, Washington, 1981.

"Deregulation, Rights and the Compensation of Losers, "in William G. Shepherd and Kenneth Boyer, eds., *Economic Regulation: A Volume in Honor of James R. Nelson*, University of Michigan Press, 1981. Also circulated as American Enterprise Institute Working Paper in Regulation, 1980.

"Social Security and Welfare: Dynamic Stagnation", *Public Administration Review*, March 1967.

OTHER PUBLICATIONS

Public Utilities Fortnightly, State Regulators' Forum, Contributor since 1992.

"Competition, Deregulation and Technology: Challenges to Traditional Regulatory Process", *In Your Interest*, Minnesota Utility Investor, Inc., 1992.

"Policing the Environment", *Institutional Investor*, October, 1992.

INCIDENTAL TEACHING AND LECTURING

University and College
Yale School of Management and Organization
Harvard Law School, Telecommunications Seminar
Suffolk University Law School
University of Maine
Boston University

Other
Edison Electric Institute
(Electricity Consumers Resource Council)

April 7, 1997

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the matter of	)	
	)	
Application of SBC Communications Inc.,	)	
Southwestern Bell Telephone Company,	)	CC Docket No._____
and Southwestern Bell Communications	)	
Services, Inc. d/b/a Southerwestern Bell Long	)	
Distance for Provision of In-Region	)	
InterLATA Services in Oklahoma	)	

AFFIDAVIT OF
ALFRED E. KAHN AND TIMOTHY J. TARDIFF

Alfred E. Kahn and Timothy J. Tardiff, being duly sworn, depose and say:

I. INTRODUCTION

1. My name is Alfred E. Kahn. I am the Robert Julius Thorne Professor of Political Economy, Emeritus, Cornell University and Special Consultant with National Economic Research Associates, Inc. (NERA). I have been Chairman of the New York State Public Service Commission and of the Civil Aeronautics Board; and in my capacity as Advisor to President Carter on Inflation, I participated actively in the successful efforts of his Administration to deregulate both the trucking industry and the railroads. I am the author of the two-volume *The Economics of Regulation*, reprinted in 1988 by MIT Press, and have written and testified extensively in the area of direct economic regulation, and particularly of the

railroad, trucking, airline and telecommunications industries. Of particular relevance to my statement here, I have also been a member of the Attorney General's National Committee to Study the Antitrust Laws (1954-56) and the National Commission on Antitrust Laws and Procedures (1978-80); I am the co-author of *Fair Competition, The Law and Economics of Antitrust Policy* and have published numerous articles in that area. I attach a copy of my full resume as Appendix A.

2. My name is Timothy J. Tardiff. I am a Vice President at National Economic Research Associates. I have specialized in telecommunications policy issues for about the last 15 years. My research has included studies of the demand for telephone services, such as local measured service and toll; analysis of the market potential for new telecommunications products and services; assessment of the growing competition for telecommunications services; and evaluation of regulatory frameworks consistent with the growing competitive trends. Most recently, I have participated in interconnection arbitrations, pursuant to the Telecommunications Act of 1996, in twelve states. I attach a copy of my full resume as Appendix B.

3. SBC Communications Inc. and its subsidiaries Southwestern Bell Telephone Company ("SWBT") and Southwestern Bell Communications Services, Inc. d/b/a Southerwestern Bell Long Distance ("SBLD")—collectively, "Southwestern Bell"—seek authority for SBLD to provide in-region interLATA services in the State of Oklahoma. The purpose of this affidavit is to assess the public interest impact of such entry.

II. THE HISTORICAL TRADE-OFF IN THE LINE-OF-BUSINESS RESTRICTIONS

A. The Issue During the Pre-divestiture Period

4. The progressive introduction of competition into the telephone business, dating back to the FCC's *Above-890* decision in 1959 and to *MCI* a decade later, and AT&T's evolving responses precipitated intense controversy at the FCC, Congress, the Antitrust Division of the Department of Justice and the courts over how best to reconcile the dominant position of the comprehensively integrated Bell System, on the one side, and the evolving national policy of encouraging competition, on the other.

5. We make no effort to recount that history.[1] We think it is not an oversimplification, however, to say that once the commitment to competition was reached at the Federal level, the central issue was the extent to which *regulatory* restraints on AT&T would be sufficient to ensure fair and efficient rivalry between it and its challengers or whether, instead, it would be necessary to break up the Bell System, imposing line-of-business restrictions on the successor companies, in order to deprive them of the power and motive to frustrate achievement of that goal. In these intense debates, AT&T and its supporters in government resolutely proclaimed the benefits of the comprehensive horizontal and vertical integration of the Bell System, and its adversaries tended to minimize those asserted benefits to the point of denying their existence entirely.

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[1] A particularly thorough history is presented by Peter Temin in, *The Fall of the Bell System, A Study in Prices and Politics*, New York: Cambridge University Press, 1987; for an account of developments and the underlying economic issues up to 1970, see Kahn, Alfred E., *The Economics of Regulation*, New York: John Wiley & Sons, 1970-71, reprinted by MIT Press, 1988, Vol. 2, pp. 126-152, 290-306.

6. What ultimately tipped the scales on the side of complete divestiture of local telephone service from the other operations of the Bell System—notably toll—was the developing view of the Department of Justice, that all the proposed protections against cross-subsidization, predation and exclusionary practices would be excessively "regulatory" and ineffective, and that only a total separation of the putatively "naturally monopolistic" local telephone service from the other potentially more competitive services would be consistent with the preservation and promotion of competition in the latter markets.

B. The Balance of Advantages and Disadvantages has Shifted

7. The terms of the trade-off between the respective benefits of integration and divestiture have changed drastically since the entry of the MFJ. In fact, whatever one's evaluation of the net advantages and disadvantages of the line-of-business restraints on the BOCs during this interval, they clearly must be reconsidered in the light of (a) the dramatically changed factual circumstances; (b) our experience with the way competition has worked in the interLATA market and increasing recognition of the important contribution that BOC entry is likely to make in intensifying that competition and extending its benefits more broadly; (c) the changes in both regulatory practice and in the market that have tended to dilute whatever power the BOCs may have had to handicap competitors; (d) the extensive experience we have actually had since 1982 with competition between the putatively monopolistic BOCs and rivals dependent upon them for essential services and (e) changes in the mix of national policies and goals articulated most clearly in the Telecommunications Act of 1996. In our judgment, all

these factors have shifted the balance of the public interest—wherever it was in 1982—unequivocally over to elimination of those absolute restrictions.

8. This proposition has now been endorsed, in both general terms of national policy and in highly specific ways, by the Telecommunications Act of 1996. We have now made our choice. The Act clearly concludes that the balance of advantages and disadvantages has unequivocally shifted in favor of abandoning the line-of-business restraints of the BOCs. It remains for us only, therefore, to spell out why the public interest criterion established by the Act for elimination of the restriction on interLATA service has clearly been met.

III. SOUTHWESTERN BELL'S ENTRY IS IN THE PUBLIC INTEREST

9. Whatever may be said in its favor, the current prohibition on interLATA entry by the RBOCs is also, undeniably, inherently anticompetitive. In the name of preserving competitive opportunities for some, it prohibits others from competing entirely. The only possible justification for its continuance would be that the gains to society from protecting the former outweigh the costs of excluding the latter and that those protections could not be achieved by other means less costly to consumers. The remaining portions of this statement consist of an amplification of our reasons for concluding—as, indeed, the Telecommunications Act of 1996 itself clearly concludes—that the balance of advantages and disadvantages has unequivocally shifted in favor of abandoning the line-of-business restraints on the BOCs.

10. The costs are great. The excluded competitors are large and potent. The market from which they are excluded—a market whose boundaries have been defined entirely arbitrarily,

so far as the relevant technology and economics are concerned—has distributed the benefits of rapidly improving productivity imperfectly and incompletely. The customers that have benefited disproportionately little are precisely the ones that the excluded BOCs would have the greatest comparative advantage in serving: those companies will therefore be the most logical and effective competitors of AT&T for residential and small business services initiated within their own regions. Unlike MCI and Sprint in 1984, they already serve all of these customers. Supplying additional services to an existing customer is far easier—and less costly—than establishing a commercial identity and presence before new ones.

A. The Current State of InterLATA Competition

11. The most fundamental change in interstate long-distance markets since the 1984 divestiture and the one most relevant in the present context is that this portion of the industry is not only dominated by AT&T, MCI and Sprint, but consists exclusively (apart from a few corridor areas that were exempted from the long-distance restriction) of companies entirely separate from—indeed antagonistic to—the successor Bell Operating Companies. In addition, the rapid development and expansion of fiber-optic technology has radically altered cost structures, much as advances in microwave technology did a decade or two earlier, and contributed to a dramatic expansion—approximately a trebling—of total network capacity in just 11 years. Whereas previously there was only the one nationwide long-distance network, totally integrated with companies accounting for some 80 percent of all local service, there are now nearly four backbone long-distance networks, fully separated from the BOCs. Those four clearly do compete with one another, as well as with a large fringe of much smaller rivals,

facilities-based and resellers. That competition is, however, far from fully effective; and its deficiencies are ones that competitive entry by the BOCs is most likely to remedy.

1. Long distance prices, access charges and margins, overall

12. Since divestiture, long-distance prices have declined—about 23 percent in nominal dollars and about 50 percent relative to the Consumer Price Index (CPI-U).[2] What is at least equally striking, however, is that these decreases have been more than fully "explained" by FCC-mandated decreases in the prices that the long-distance carriers pay to the local exchange carriers for access to their networks. According to the FCC, the average interstate switched access charge per conversation minute fell about 65 percent from May 1984 to May 1996.[3] This would translate to a decline of $0.11 per conversation minute. To make this reduction possible, the FCC imposed monthly subscriber line charges directly on telephone customers, shifted costs to the intrastate jurisdiction through changes in separations rules and adopted price cap formulas that mandated reductions over time in the remaining local exchange carrier interstate carrier access revenue requirements.

13. According to a recent estimate, therefore, AT&T's annual carrier access bill dropped by about $10.3 billion between 1984 and 1994 (holding volumes constant, in order to reflect the pure change in price), while over the same period of time the bills that its customers received fell by about $8.5 billion (once again holding volumes constant). Thus, despite massive competitive advertising and the active competition for large business customers to

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[2] As measured by the consumer price index for interstate long-distance. U.S. Department of Labor, Bureau of Labor Statistics, Office of Publications, Division of Information Services.

[3] Federal-State Joint Board Staff, *FCC Monitoring Report*, May 1996, Table 5.11, p. 474.

which it was subjected in the interstate long distance markets, AT&T was still able to raise its prices relative to access charges and collect an additional $1.8 billion per year.[4]

14. The contrast between the changes in access charges and prices since 1994 have become even more striking: while access charges have continued to fall, prices have risen. Access charges per conversation minute have decreased by about 10 percent since January 1994.[5] Simultaneously, AT&T has increased the basic rate for residential interstate calling by over 20 percent.[6] Obviously since 1994 basic rates and access charges have not changed to the same degree—they have not even changed in the same direction. Indeed, during 1996 alone, interstate toll prices (as measured by the CPI-telephone, interstate) increased by 3.7 percent—substantially more than the 2.9 percent rate of increase in the CPI).[7]

15. The long-distance carriers have strongly criticized the high charges they typically have to pay the LECs for access to their networks. Those charges have indeed been set by regulators far above cost, deliberately, in order to perpetuate the subsidy that had, before AT&T was split up, flowed from similarly inflated long distance charges to hold down the rates for

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[4] Taylor, William E., "Competition in the Interstate Long-Distance Markets: Recent Evidence from AT&T Price Changes," filed in CC Docket No 94-1 (March 1995), pp. 4-5. We emphasize that the evidence we present here is of the change in prices alone, for given volumes of usage. This is not the same as average revenue per minute.

[5] Federal-State Joint Board Staff, *FCC Monitoring Report*, May 1996, Table 5.11, p. 474.

[6] In the price hike of January 1994, basic residential rates rose by an average of 6.3 percent ("AT&T Proposes $750 Million Rate Hike, New Calling Plan Aimed At High-Volume Residential Users," *Telecommunications Reports*, January 3, 1994). Rates further increased in December 1994 by 3.7 percent ("AT&T and Rivals Boost Rates Further," *Wall Street Journal*, November 29, 1996, p. A3). Following a year of no rate increase in 1995 as it had promised ("AT&T Proposes Consumer Price Changes, Discounts," *Telecommunications Reports*, February 20, 1995), AT&T put into effect a basic rate increase of 4.3 percent and 5.9 percent in February and December 1996, respectively ("AT&T Follows MCI, Sprint with Long Distance Rate Increases," *Telecommunications Reports*, December 2, 1996).

[7] U.S. Department of Labor, Bureau of Labor Statistics, Office of Publications, Division of Information Services.

basic residential service. By any measure, however, AT&T's own average markups above those access charges and above its own long-run incremental costs continue to be larger than the markups in the access charges themselves.

16. In 1994, for example, AT&T's reported revenue per minute averaged 18 cents; its reported carrier access payments averaged 6 cents per (conversation) minute.[8] Incremental toll costs are estimated at 1 - 2 cents per minute[9] and carrier access incremental costs at half that level or less (per conversation minute).[10] Thus, while a group of economists assembled by AT&T are correct in asserting that

> (i)f there is one factual issue in the telecommunications industry upon which there is virtually unanimous agreement, it is that carrier access services are currently priced well in excess of their incremental costs[11]

they are wrong in their selectively pejorative treatment of those particular prices. While the LECs mark up their carrier access prices over incremental cost by (say) a nickel, AT&T marks up long distance prices over incremental cost by a dime. Thus the AT&T economists are wearing blinders when they condemn the former markup as a "regulatory-sanctioned pricing distortion"—"clearly an anathema to economic efficiency," with cumulative social costs "certain to run into the billions of dollars per year" (at 27)—while AT&T itself extracts roughly

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[8] AT&T *ex parte* letter in CC Docket No. 94-1, March 21, 1995.

[9] Perl, Lewis J. and Jonathan Falk, "*The Use of Econometric Analysis in Estimating Marginal Cost*," Presented at Bellcore and Bell Canada Industry Forum, San Diego, California, April 6, 1989, Table 2. See also Crandall, R.W. and L. Waverman, *Talk Is Cheap,* Washington: Brookings, 1996, p. 92.

[10] AT&T economists cite incremental costs of carrier access between 1/3 and ½ cents per minute (at 27). They are silent on the question of long distance incremental costs. D. Kaserman, J. Mayo, M. Crew, N. Economides, G. Hubbard, P. Kleindorfer and C. Martins-Filho, "Local Competition Issues and the Telecommunications Act of 1996," prepared on behalf of AT&T, July 15, 1996.

[11] *Ibid.*, p. 26

twice that markup per minute in its own retail toll rates, in a market it claims to be fully competitive.[12]

[12] Our contrast between the apparent markups above incremental cost contained in the carrier access charges of the ILECs, on the one side, and AT&T's toll rates, on the other, is of course sensitive to the estimate we employ for the LRIC of the latter operations. Since we now have an explicit estimate of the "long-run incremental costs of long-distance" of "between $0.03 and $0.08 per minute (including sales and administrative costs)," by Crandall and Waverman (*op.cit.*, p. 181), it seems desirable to take this later estimate into account in attempting to put these two respective markups in perspective.

To this end, we make the following additional observations:

- Our 2 cents per minute figure was the top of the 1 to 2 cents range estimated by Perl and Falk.
- In making the first of their welfare-loss calculations, Crandall and Waverman themselves allude to their "assume[d] 2 cents per minute" incremental cost (p. 92, stress supplied), which they then refer to in an attached footnote as "our 2 cent per minute estimate" (p. 94, stress supplied). And in their conclusory chapter, they say that "the incremental costs of long-distance service is probably no more than 5 cents and surely no more than 10 cents per minute" (pp. 276-77), citing the Company's reported marketing and customer service and general and administrative costs, which they take to be on the order of 3.9 cents and 2.9 cents per minute (p. 142), respectively. While a large portion of the former costs are probably part of the Company's TSLRIC (as contrasted with the LRIC of smaller increments), it seems highly unlikely that that would be true also of the general and administrative costs.
- In any event, the authors' assertion that "it [would be] unwise to estimate AT&T's marginal costs as simply 1 cent per minute over and above access costs and conclude the prices should fall to this level" (p. 144) is based on the proposition, with which we are in total agreement, that prices would have on average markedly to exceed incremental costs even in competitive equilibrium—that is, if total forward-looking costs were to be recovered—a proposition that applies equally to the ILECs.
- We observe, only in passing, that Paul W. MacAvoy uses an estimate of LRIC for long-distance calling at 1 cent (*The Failure of Antitrust and Regulation to Establish Competition in Long-Distance Telephone Services*, MIT and AEI Presses, 1996, p. 115), citing an estimate by Wharton Econometric Forecasting Associates and that a recent report by Lehman Brothers (*Telecom Services: Buy the Bundle Builders, Get the Growth*, March 18, 1996, p. 28) includes an estimate of long-run incremental cost: "Large customers and large resellers can purchase transport at close to long-run incremental costs, or at about the $0.02 per minute in average depreciation and network engineering costs of the major players (this is the rate that the federal government recently negotiated on its multiyear FTS 2000 contract for POP-to-POP transport)." It seems likely, however, that these figures fail to include such marketing, customer service and overhead costs as would indeed be properly part of the LRIC of the total service.

If, then, we were to have employed the Crandall-Waverman estimate of the "probable" ceiling of 5 cents per minute, our comparison would show AT&T marking up its retail long-distance prices on average by at least 7 cents above incremental cost plus access, compared with the 4 cents by the LECs that has so bitterly offended its economists.

2. Distribution of the benefits of competition between large and small users

17. Large business customers have benefited greatly from the new competition in the long distance business. The combination of the large volume of their business, on the one side, and, on the other, the very wide gap between the incremental costs of the IXCs and their average rates has forced the IXCs into intense competition in offering special contractual arrangements, incorporating both special prices and new and superior service offerings. As the FCC has observed, large customers now solicit proposals from multiple vendors and negotiate terms directly with the interexchange carriers.[13]

18. The price reductions have been dramatic: the average cost for a minute of long distance service for a large corporation appears to have fallen by about 80 percent (nominally, and even more in inflation-adjusted dollars) since 1983.[14] Prices in 1983 were at about 35 cents per minute and are now at about 7 cents per minute for the largest business customers.[15]

19. Small residential subscribers have not benefited to anything like the same degree. In contrast with the estimated 80 percent decline for large business customers, long distance prices for residential consumers (as measured by the CPI) declined by about 29 percent from 1984 through the beginning of 1994. Since AT&T reported an average revenue per minute

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[13] Report and Order, In the Matter of Competition in the Interstate Interexchange Marketplace, CC Docket No. 90-132, FCC, 6 FCC Rcd. 5880, 5887, Adopted: August 1, 1991, Released: September 16, 1991, par. 38.

[14] Felix, Michael T., "Preparing the Market for Enhanced Service Implementation," *Telephony*, Vol. 230, No. 13, March 25, 1996, p. 40.

[15] Rohde, David, "VPN Rates On The Way Down," *Network World,* December 2, 1996, Vol. 13, No. 4g, pp. 1, 14-15; Table 7.12, *Statistics of Communications Common Carriers*, Federal Communications Commission, 1988/1989 Edition, p. 286; Felix, "Preparing the Market...," *Telephony*, p. 40; Crandall & Waverman, *Talk Is Cheap*, 1993, p. 125; "GSA Tells Congress FTS 2000 Prices Beat Market Rates," *Telecommunications Reports*, March 8, 1993.